1st December 2023

Director, Crypto Policy Unit
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Dear Director,

Australian Custodial Services Association Submission on "Regulating Digital Asset Platforms"

The Australian Custodial Services Association (**ACSA**) is the peak industry body representing members of Australia's custodial and investment administration sector. Our mission is to promote efficiency and international best practice for members, our clients, and the market. Members of ACSA include NAB Asset Servicing, J.P. Morgan, HSBC, State Street, BNP Paribas Securities Services, Citi, Clearstream and The Northern Trust Company.

Collectively, the members of ACSA hold securities and investments in excess of AUD $4.7 trillion in value in custody and under administration for Australian clients comprising institutional investors such as the trustees of major industry, retail and corporate superannuation fund, life insurance companies and responsible entities and trustees of wholesale and retail investment funds. Those institutional investors are responsible for a sizable proportion of the money invested and held for Australian retail investors. ACSA member services are therefore integral to supporting the investment and retirement savings of a large part of the Australian population.

A key priority for ACSA is ensuring that future regulation allows for efficient and effective market operations that ensure adequate investor protection, particularly for institutional and wholesale investors.

ACSA has formed an industry working group made up of ACSA members with local and global experience relating to digital assets and custody, which enables ACSA to provide consultation inputs to "Regulating Digital Assets Platforms". We support the Treasury's efforts to introduce a regulatory framework for entities providing access to digital assets and holding them for Australians and Australian businesses.

DETAILS OF SUBMISSION

ACSA recognizes the importance of the proposed regulatory framework to mitigate risk and promote innovation in the uses of digital assets in Australia. We support approaches taken by the Treasury to ensure that digital assets platforms are subjected to appropriate regulation, while ensuring that Australia is still accessible to existing and new entrants.

Overall, ACSA welcomes this proposed regulatory framework as it could help provide clarity and further advancement of regulatory regimes. ACSA encourages reference to global standards to support our role in the global financial ecosystem.

We support the adaptation of the Australian Financial Services License (AFSL) regime to encompass digital asset facilities, as outlined in Question Set 4. While acknowledging the objective of ensuring orderly business winding up, ACSA emphasizes the need for transparent rationale behind the Net Tangible Assets (NTA) obligations to bring clarity to the market. However, whilst the desire to support the evolution of the market is important, ACSA is concerned that there is a disparity between regulatory risk capital being proposed to maintain assets in a digital platform ($5million) against risk capital for traditional financial products/assets held in custody ($10million/1% revenue). This creates the opportunity for arbitrage of capital risk through tokenisation of assets and allows for the maintenance of lower risk capital levels for the safekeeping and custody of superannuation and investment fund assets invested in tokenised and digital assets than those invested in mature traditional financial products such as shares and bond markets. Whilst stringent NTA requirements may pose barriers to innovation and limit the growth of the custodial services market, reduced levels of risk capital also introduces differential market and investment risk for digital platform assets against traditional financial products as there are lower risk capital requirements to protect investor assets in digital asset platforms. ACSA recommends tailoring NTA based on platform provider activities and supports the distinction between custodian and non-custodian NTA in the digital asset context, but urges careful consideration of the associated implications.

In response to the Treasury's proposal on minimum standards for holding digital assets, we concur with the overall approach but recommend a focused application solely to digital assets classified as financial products. Aligning with ASIC's standards for asset holders is essential for investor protection, emphasizing organizational structures, staffing capabilities, and adequate resources. We propose stringent measures, including the segregation of client assets, protection against insolvency, and the application of capital and liquidity requirements. We advocate for a trust structure mirroring ASIC's RG 133.51, considering the unique infrastructure required for digital bearer tokens. Furthermore, we recommend enhanced risk reviews, independent audits, meticulous reconciliation practices, and robust disclosure requirements.

ACSA expresses support for the proposed additional standards for token holders, aligning with the non-prescriptive approach prioritizing asset safety and security in accordance with recent IOSCO policy recommendations. We advocate for global consistency in standards for holding digital assets and tokens. Regarding continuous monitoring and routine audits, ACSA suggests extending audits to both the digital assets trading platform and custody software, with detailed audit log requirements to enhance transparency and security. We are also advocating for the prohibition of manual deletion of audit files for data integrity. Concerning tokens held by third-party sub-custodians, ACSA recommends additional provisions to address heightened risk exposure, particularly in foreign jurisdictions, aligning with IOSCO's concerns. Additional discussion points were raised, such as the advocating for guidelines on insurance requirements in case of theft, an annual review of operational and technology risk frameworks, and an independent annual audit of custody software or service providers, consistent with IOSCO's recommendations.

On token staking, we would like to express broad support for the Treasury's regulations, urging consideration of diverse models beyond centralized staking. Other staking models we called out include delegated staking and decentralized pooled staking. We've identified several important considerations related to centralized staking, including the licensing and registration requirements, management of pooled assets and the complexities of staking and unstaking. In addition to cybersecurity and key management, we stress the importance of robust risk and control measures, particularly in handling staking and unstaking instructions. Implementation of user access controls and maker/checker protocols becomes imperative to mitigate risks effectively.

Lastly, it is worth noting that while the overall model outlined in the consultation for digital asset platforms is quite broad as it applies to all digital assets, the consultation notes that intermediaries of digital assets that are financial products would continue to be subject to relevant authorization requirements applicable to financial products, the proposed framework would also apply and provide supplementary obligations with respect to digital assets. While there is logic to this model, we note that there is also a risk of introducing additional and possibly overlapping requirements instead of providing greater clarity for use cases such as tokenization. We note that other markets have taken a different view, with crypto frameworks being applied to cryptocurrencies only (i.e. BTC and ETH), leaving laws governing securities/financial instruments to govern security tokens.

Thank you again for the opportunity to participate in this consultation. Please contact me if you have any comments about this submission.

Yours sincerely

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About ACSA

[***www.acsa.com.au***](http://www.acsa.com.au)

Custodians provide a range of institutional services, with clients typically favouring a bundled approach to custody and investment administration. Solutions may include traditional custody and safekeeping, investment administration, foreign exchange, securities lending, tax and financial reporting, investment analytics (risk, compliance and performance reporting), investment operations middle office outsourcing and ancillary banking services.

These services represent key investment back office functions – often representing the client's asset book of record and essential source data in relation to the investments they hold.

The key sectors supported by ACSA members include large superannuation funds and investment managers, as well as other domestic and international institutions.

ACSA works with peer associations, regulators and other market participants on a pre-competitive basis to encourage standards, promote consistency, market reform and operating efficiency.
Note: The views expressed in this letter are prepared by ACSA for the purposes of consideration by The Treasury in response to "Regulating Digital Asset Platform" and should not be relied upon for any other purpose. The comments in this letter do not comprise financial, legal or taxation advice and should not be regarded as the views of any particular member of ACSA.

Appendix.

"Regulating Digital Asset Platform" Detailed Response
1 Dec 2023

Questions (Set 1)

Prior consultation submissions have suggested the Corporations Act should be amended to include a specific 'safe harbour' from the regulatory remit of the financial services laws for networks and tokens that are used for a non-financial purpose by individuals and businesses.
What are the benefits and risks that would be associated with this? What would be the practical outcome of a safe harbour?

Not Answered

Questions (Set 2)

Does this proposed exemption appropriately balance the potential consumer harms, while allowing for innovation? Are the proposed thresholds appropriate?

How should the threshold be monitored and implemented in the context of digital assets with high volatility or where illiquid markets may make it difficult to price tokens?

Not Answered

Questions (Set 3)

What would be the impact on existing brokers in the market? Does the proposed create additional risk or opportunities for regulatory arbitrage? How could these be mitigated?

Not Answered

Questions (Set 4)

Are the financial requirements suitable for the purpose of addressing the cost of orderly winding up? Should NTA be tailored based on the activities performed by the platform provider?

Does the distinction between total NTA needed for custodian and non-custodian make sense in the digital asset context?

ACSA **agrees with the adaptation of the AFSL regime** for the provision of a financial services business in Australia in relation to digital asset facilities, with regards to Question Set 4.

While we **support the objectives** to ensure orderly winding up of operations, we believe the **rationale and basis** behind the Net Tangible Assets (NTA) requirements should be provided to bring transparency and clarity to the market.

ACSA is concerned that the proposed NTA requirement for custody services of $5million enables a lower level of risk capital to be required for the provision of custody of tokenised and digital platform custody against the need for $10million (or 1% of revenue) for custody of traditional financial products. The concern is the premise that a lower level of risk capital needed to meet NTA requirements for digital platforms gives the perception that digital platforms are less risky than custody of traditional financial products such as cash, shares and bonds. Additionally, the lower risk capital for a digital platform would seem to promote the tokenisation of traditional financial products to digital platforms which then means that superannuation and investment funds assets are no longer protected by the levels of risk capital and NTA backing they experience through custody arrangements for traditional financial products and existing regulatory capital requirements for such services.

ACSA acknowledges that NTA obligations could **provide additional barriers** to innovation and competition for custodial service providers, limiting the provision of custodial service to a small set of providers, however ACSA believes it is important to have a level playing field and consistent risk capital requirements to protect the interests of investors (including superannuation funds) in the provision of custody services for all financial products, tokenised, digital or traditional.

We consider the tailoring NTA based on the activities performed by the platform provider a **valid approach** to take.

Referring to 3.1 (g) (iii), ACSA is of the view that the distinction between total NTA needed for custodian and non-custodian is **valid in the context of digital assets**. However, we would **reiterate our above comments on the proposed NTA** requirements for consideration.

Questions (Set 5)

Should a form of the financial advice framework be expanded to digital assets that are not financial products? Is this appropriate? If so, please outline a suggested framework.

Not Answered

Questions (Set 6)

Automated systems are common in token marketplaces. Does this approach to pre-agreed and disclosed rules make it possible for the rules to be encoded in software so automated systems can be compliant?

Should there be an ability for discretionary facilities dealing in digital assets to be licensed (using the managed investment scheme framework or similar)?

Not Answered

Questions (Set 7)

Do you agree with the proposal to adopt the ‘minimum standards for asset holders’ for digital asset facilities? Do you agree with the proposal to tailor the minimum standards to permit ‘bailment’ arrangements and require currency to be held in limited types of cash equivalents? What parts (if any) of the minimum standards require further tailoring?

The ‘minimum standards for asset holders’ would require tokens to be held on trust. Does this break any important security mechanisms or businesses models for existing token holders? What would be held on trust (e.g. the facility, the platform entitlements, the accounts, a physical record of ‘private keys’, or something else)?

Referring to page 13 of the Treasury's proposal paper under 'Minimum standards for holding assets' –"In addition, the minimum standards would permit additional types of 'true' custody arrangements for non-financial products, such as bailment. This tailoring means digital asset facilities would be able to safely hold any type of asset. The minimum standards for holding assets will apply to all digital asset facilities, including 'custody only arrangements.", we broadly agree with the Treasury's approach, however, we would like to **limit our response to digital assets that are financial products only**.

We agree with the proposal that the 'minimum standards for asset holders' as set out by ASIC, including adequate organizational structures, staffing capabilities, adequate capacity and resources should apply for digital asset facilities that offer services for digital assets that are financial products. We believe that it is essential for investor protection, to ensure digital asset facilities should be **treated with similar principles** when it comes to applying minimum standards and requirements on asset holders.

In addition, we recommend that requirements should be introduced to ensure the **segregation of client assets from those used for operational, business, or other purposes**, and ensure that assets are appropriately **ring-fenced from insolvency** at all times and apply appropriate **capital and liquidity requirements** to protect against residual risks.

Digital assets that are financial products should be held in trust with the exceptions applied as in RG 133.51 of ASIC's regulatory guide: RG 133 Funds management and custodial services: Holding assets, similar to how the requirement applies to traditional financial products currently. Typically, holding a digital bearer token requires specialized wallet infrastructure and the technical custody is the safekeeping of the private keys of the wallets that allows for signing of transactions that allow movement of these digital assets. **What may be safekept - private keys, the accounts, etc. is a legal question that requires detailed legal analysis, however the focus take into account what it represents, and the trust must hold that which represents the digital asset, with the ability for the trust to have full control over the digital assets that is held in trust**.

Considering the nature of the asset, we recommend assets holders to:

- **Perform enhanced review** of the associated risks and ensure appropriate management and reasonable compliance controls beyond existing control frameworks that are applicable to traditional assets. The regulator may also consider **stipulating requirements** in addition to internal audits, such as periodic independent audits on the system and controls managing the risk of custody of digital assets
- **Ensure appropriate reconciliation practices** that are enhanced to cover the specific risks introduced by the concept of digital assets. For example, ensuring the appropriate mapping of wallets to accounts in custody book of records, and the reconciliation of client asset holdings as recorded on the public blockchains versus internal system records
- Apply **appropriate disclosure requirements** to their clients, including providing detailed disclosure of IT-related risks, fraud and cybersecurity risks, third-party risks, etc. and share their operational resilience framework
- Hold assets in **cold custody**, as an option to ensure additional protection to investors. We believe that storing digital assets offline and inaccessible to third parties in cold wallets stands as the safest way of storage
- **Offer their services on a continuous, 24/7/365 basis**. This should include several services, including deposit and withdrawals, monitoring and surveillance, as well as live customer support services
- **Cater for redemption of digital assets to be as timely as possible**, at real-time or near real-time redemption even in times of extreme stress

Questions (Set 8)

Do you agree with proposed additional standards for token holders? What should be included or removed?

ACSA supports the proposed additional standards for token holders. The non-prescriptive approach while **prioritizing the safety and security of assets** are consistent with the recent policy recommendations by IOSCO (May, 2023). ACSA encourages the creation of a **global and consistent set of standards** in relations to the holding digital assets and tokens.

On point (i) "…highest level of safety…", we recommend implementing an **operational and technology risk framework** that is **reviewed annually** given the nascency of the asset class.

On point (ii) "…on continuously monitored and routinely audited…", we have the following recommendations:

- Auditing should be conducted across **the digital assets trading platform, custody software, custody software provider and third party custodian**
- **Independent audit** of the custody software and/or its service provider on an **annual basis**; in alignment with IOSCO's recommendation (pg. 38, May 2023)
- Manual deletion of audit files should be **strictly forbidden** in all scenarios
- Expanding info box 11 to cover best practices and recommendations on **system and organisation controls audits** performed by independent auditor, and published as a SOC 1 Type II report. We believe that the SOC 1 Type II report to be a well-established and accepted form of attestation over information security controls
- **Full transparency** of the auditing outcome should be made available to investors
- Whenever applicable, the following information should be captured by the audit logs: (1) Login/logout activity (successful and unsuccessful); (2) Unsuccessful access attempts, (3) Environment changes (software upgrades, etc.); (4) Insert, update, or delete of client data or other sensitive production information; (5) Date and time of activity and (6) all relevant event information (before and after values)

On point (iv) "…held by a third party sub-custodian…":

- Provisions should be made on the engagement of third party sub-custodians as it might **result in additional risk exposure**, especially if tokens are held or placed in foreign jurisdiction that would impact asset protection and insolvency claims. The additional risk has also been raised by IOSCO (pg. 34, May, 2023)

In addition, we are raising the following discussion points for considerations:

- While the tokens needs to be safeguarded with the highest standard of safety, additional considerations and guidelines on the requirements for **insurance and protection** could also be put in place in case of theft (e.g. hacks of custody software resulting irreversible loss of private keys)
- Additional standards on security, monitoring and auditing should also be **extended to the smart contracts** used by the digital assets trading platform to ensure compliance
- Segregation of tokens held on behalf of clients from proprietary holdings should be **made compulsory**, unless explicit consent from the clients to do so

Questions (Set 9)

This proposal places the burden on all platform providers (rather than just those facilitating trading) to be the primary enforcement mechanism against market misconduct.

Do you agree with this approach? Should failing to make reasonable efforts to identify, prevent, and disrupt market misconduct be an offence?

Should market misconduct in respect of digital assets that are not financial products be an offence?

Not Answered

Questions (Set 10)

The requirements for a token trading system could include rules that currently apply to 'crossing systems'[87] in Australia and rules that apply to non-discretionary trading venues in other jurisdictions.

Do you agree with suggested requirements outlined above? What additional requirements should also be considered?

Are there any requirements listed above or that you are aware of that would need different settings due to the unique structure of token marketplaces?

Not Answered

Questions (Set 11)

What are the risks of the proposed approach? Do you agree with suggested requirements outlined above? What additional requirements should also be considered?

Does the proposed approach for token staking systems achieve the intended regulatory outcomes? How can the requirements ensure Australian businesses are contributing positively to these public networks?

ACSA is broadly supportive of the Treasury's approach to regulate token staking. We would encourage the **consideration of additional staking models** apart from the centralized pooled model. Other staking models to consider includes, (i) **delegated staking**, where the client instructs service providers to send their tokens to a third-party validator for staking and (ii) **decentralized pooled staking**.

Important considerations vis-à-vis a centralized pooled staking model include:

- Whether an investment into the centralized staking pool constitutes a securities offering by the staking provider, and what licensing and registration requirements applies
- Expertise to manage pooled assets and where/when/how to stake and "unstake" (esp. in models where "unstaking" is allowed any time)
- Other risk and controls considerations, in addition to those mentioned. A key risk (besides cybersecurity/ key management) would be staking/unstaking instructions, which would require the provider to implement user access and/or maker/checker controls

Lastly, we also like to recommend having **greater clarity** around the **roles and responsibilities of a custodian**, when it is staking the tokens on behalf of its customers.

Questions (Set 12)

How can the proposed approach be improved?

Do you agree with the stated policy goals and do you think this approach will satisfy them?

Not Answered

Questions (Set 13)

Is requiring digital asset facilities to be the intermediary for non-financial fundraising appropriate? If so, does the proposed approach strike the right balance between the rigorous processes for financial crowdsource funding and the status quo of having no formal regime?

What requirements would you suggest be added or removed from the proposed approach? Can you provide an alternate set of requirements that would be more appropriate?

Not Answered

Questions (Set 14)

Do you agree with this proposed approach? Are there alternate approaches that should be considered which would enable a non-financial business to continue operating while using a regulated custodian?

Not Answered

Questions (Set 15)

Should these activities or other activities be added to the four financialised functions that apply to transactions involving digital assets that are not financial products? Why? What are the added risks and benefits?

Not Answered

Questions (Set 16)

Is this transitory period appropriate? What should be considered in determining an appropriate transitionary period?

Not Answered